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Stable Value Funds Represent Attractive Alternative to Money Market Funds

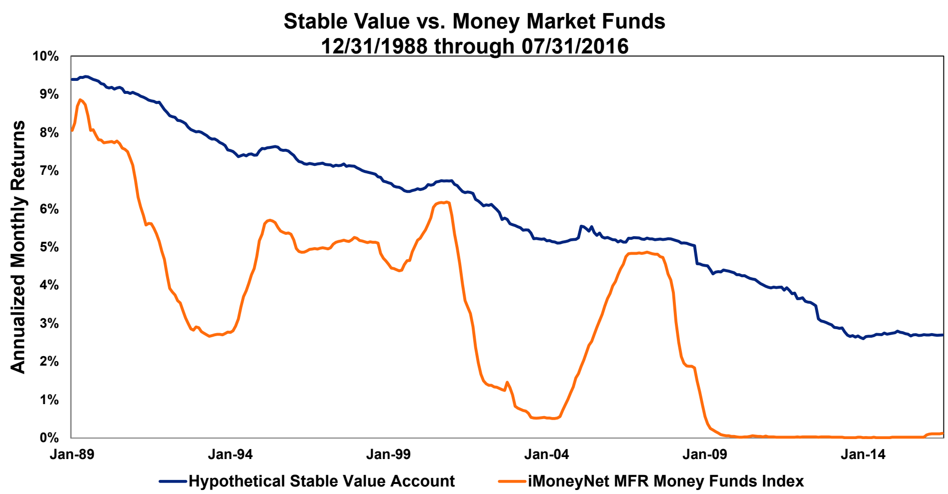
Employers are increasingly aware of the importance of a robust retirement plan in contributing to the long-term well-being of their employees. The performance of plan participants' investments can significantly impact their financial security in retirement. During market fluctuations, participants value the ability to protect their hard-earned principal, while also striving to maximize returns to ensure their retirement savings will last as long as 30 to 40 years.

Traditionally, many defined contribution (DC) plans have offered money market funds as the low-risk, principal-preservation option. However, changes in the U.S. regulatory environment and the low level of interest rates here and abroad are prompting plan sponsors to re-evaluate their plans' low-risk options and consider stable value funds for their safety, liquidity and growth. With this commentary, we hope to shed some light on the potential impact of recent regulatory changes, while exploring the three most common types of stable value funds.

What is changing in regards to money market funds, and what does it mean for your DC plan?

The 2008 financial crisis exposed many rifts in the U.S. financial system. At least one large prime money market fund — long-trusted for guaranteeing principal — "broke the buck," meaning its net asset value (NAV) fell below $1.00. For investors, this meant a potential loss of principal in a money market fund.

As a result, the Securities and Exchange Commission (SEC) has required prime institutional money market funds, which are often found in retirement plans, to make significant changes effective October 14, 2016. With these changes, the funds are required to have a floating NAV instead of the constant $1.00 NAV. This means investors could lose principal in prime money market funds. While the public has historically viewed money market funds as a safe place to preserve principal, they may no longer fulfill that role. Also, institutional prime money market funds are now permitted to apply liquidity "gates" to slow redemptions at the discretion of the fund's board. This could lead to reduced liquidity, which would weaken, if not erase, another long-time selling point of money market funds.



Over the long term, stable value funds have consistently generated higher returns than money market funds.

Source: The Stable Value Investment Association

As a result of these changes, many plan sponsors have converted institutional prime money market funds to government money market funds, which are exempt from the SEC's new redemption restrictions. Government money market funds must maintain a constant $1.00 NAV and may not institute liquidity gates. Therefore, they continue to fulfill the money market fund's longtime function of protecting principal and ensuring liquidity.

However, government money market funds are not the panacea they may appear to be. Government money market funds have, on average, yielded at least 10 basis points less than prime funds over the two-year period ended August 31, 2016.[1] Therefore, a conversion from institutional prime money market funds to government money market funds will almost certainly have the effect of reducing participant yields. Our expectation is that the spread will widen over time.

In our judgment, the current environment makes stable value a more attractive alternative for plan sponsors seeking low volatility and higher yields.

[1] *Securities and Exchange Commission: https://www.sec.gov/divisions/investment/mmf-statistics/mmf-statistics-2016-8.pdf*

What are stable value funds, and how do they work?

Stable value funds are an investment vehicle available only within DC plans. They consist of a diversified portfolio of fixed-income securities that are paired or "wrapped" with insurance, known as a "wrap contract." In a wrap contract, the insurance company guarantees the invested principal amount and pays a predetermined rate of return for a set period of time. Therefore, stable value funds provide a steady yield while preserving the investor's principal, regardless of market fluctuations.

As part of a balanced portfolio consisting of stock funds for growth, stable value funds provide diversification and can reduce overall portfolio risk. They offer the stability and liquidity of money market funds, but with returns on par with bond funds. Designed to outperform money market funds, stable value funds have played an important role in retirement plans for several decades and will likely play a growing role in the years to come.

Stable value fund type 1: Individual Managed Separate Accounts

Individual managed separate accounts are tailored to each entity's investment needs. The stable value manager constructs and manages the underlying fixed-income portfolio and negotiates and implements wrap contracts with insurance companies. The primary advantage of this arrangement is that it can be customized to each plan's unique objectives, guidelines and risk tolerance. The plan retains the authority to make a manager change (within reason, according to wrap contract language), to advocate for key risk considerations to be covered in wrap agreements, and to replace wrap issuers due to credit risk or other factors. This type of arrangement requires some critical mass; typically, it is advisable only if the fund's assets total more than $50 million.

Stable value fund type 2: Collective Fund

A collective fund — usually a bank-sponsored trust — is managed on behalf of multiple plans that are pooled together. The major benefit of this structure is that it enables smaller stable value funds to access the stable value market and ideally gain efficiencies of scale, such as potentially lower fees.

One key feature of the collective, or commingled, fund is that individual plans may exercise their right to exit the fund at book value rather than market value. In other words, they can leave with the amount they originally invested in the fund even if the market value has dropped. It may make sense for a DC plan to leave a collective fund if the plan's share of the fund has grown to a size where it could operate as an individual account. Keep in mind that one or two years' advance written notice is typically required to exit a collective fund.

Stable value fund type 3: Insurer Separate Account (Annuity)

A single insurance company offers an insurer separate account either in the form of a separate or general account annuity contract. Part of the appeal of this approach is that the insurer may offer a minimum rate guarantee above the zero percent floor typically found in other wrap agreements.

With the two stable value fund types described previously, duties are divided between two parties: an independent investment adviser manages the investments, and an insurance company issues the wrap agreement contract. However, be aware that with the insurer separate account, the insurer wears both hats, and this presents some potential risk. The insurer decides how the assets are managed and determines the contract terms, including the plan sponsor's flexibility to terminate. A recent flurry of stable value litigation, directed primarily at large insurance providers, is unsettling to plan sponsors. Therefore, it has never been more important to understand and negotiate contract terms prior to signing on the dotted line.

In conclusion, stable value funds offer an excellent option for the principal preservation component of a DC plan. Due to recent regulatory and market changes, as well as the continued compression of interest rates, stable value funds have the potential to continue to provide a greater yield than money market funds while offering the benefits of daily liquidity and principal preservation. We believe this is an opportune time for plan sponsors to review the fixed-income investments in their retirement plan and either consider a move to stable value or confirm that their existing strategy is positioned for the regulatory and market challenges ahead.